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Commonwealth of Massachusetts

Special Commission on Tax Reform

The Burden and Composition of Massachusetts' Revenue System

Commonwealth of Massachusetts
Special Commission on Tax Reform
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Introduction

Some critics of Massachusetts' revenue system contend that it is not "competitive," that is, it discourages businesses from locating and expanding within its borders. Others contend that the system distributes revenue burdens unfairly.

Assessing the competitiveness of Massachusetts' revenue system is no easy task. Those who have attempted to do so frequently compare the Commonwealth with other states in terms of the total revenue burden they impose on their residents. This study traces and explains how the revenue burden on Massachusetts' residents has changed over time. It compares Massachusetts' revenue burden with the average imposed by all states and with a group of states generally considered to be Massachusetts principal economic competitors.

Evaluating the fairness of the distribution of revenue burdens within the Commonwealth is also difficult. Many policymakers who believe that the Commonwealth's revenue burden is distributed unfairly cite imbalances in the system's revenue mix. They argue that by relying too heavily on certain taxes, the Commonwealth is requiring some groups of citizens to pay too large a share of the cost of government. Analyzing the composition of Massachusetts' revenue provides other useful insights, such as the extent to which the Commonwealth relies on taxes that are relatively visible, and its division of fiscal authority between the state and its municipalities. With these concerns in mind, this study compares Massachusetts with the nation as a whole and selected groups of states in terms of the relative importance of principal state and local taxes; the distribution of revenue between tax and non-tax revenues, such as charges and user fees; and the distribution of revenue between state and local governments.

Principal Findings of the Study

1. The revenue burden on citizens of the Commonwealth has fallen dramatically in recent years. The single best measure of revenue burden, total taxes and fees paid to state and local governments as a percent of statewide income, has dropped each year from 1977 to 1984.

- *The revenue burden fell from 17.7% in 1977 to 14.7% in 1984.*

- *A decrease in the property tax burden, the ratio of property tax revenues to personal income, accounted for most of this decline. The property tax burden fell from 7.4% in 1977 to 4.0% in 1984.*

2. The revenue burden on Massachusetts' residents is low relative to the average state and local burdens borne nationwide. Massachusetts' revenue burden is also lower than the average of states thought to be Massachusetts' principal competitors.

- *In 1984 the revenue burden on Massachusetts'residents was 14.7%, while the national average was 16.4%.*

- *For neighboring New England states, the revenue burden was 15.4%; for a selected group of "industrial" states it was 16.7%; and for a selected group of "high technology" states it was 15.8%.*

3. There are significant differences in the revenue mix of the Commonwealth and that of other states.

- *Relative to the national average, the Commonwealth relies more on such visible taxes as the personal income tax and the property tax, and less on such relatively unnoticeable revenue sources such as the sales tax, user fees, and especially local non-property taxes.*

- *Fiscal Authority is more centralized in Massachusetts than in other states. Massachusetts relies more heavily on revenues gathered at the state level, while other states rely more heavily on revenues collected at the local level.*

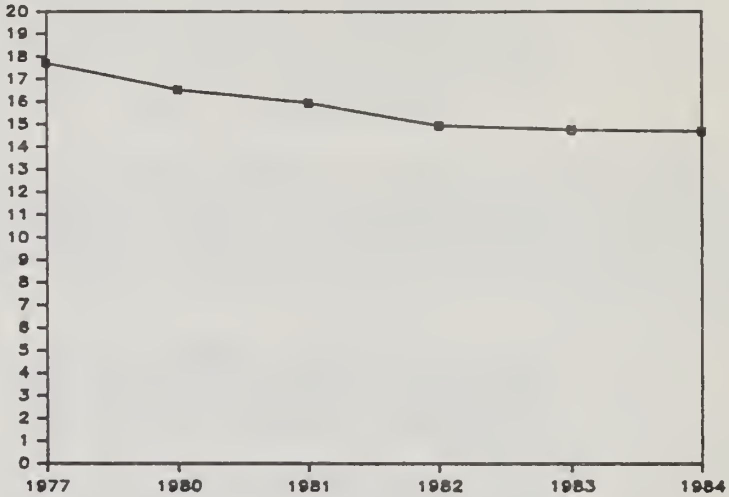
The Falling Revenue Burden

In evaluating the "burden" of taxes, one should look at their proceeds relative to the ability of residents to pay them. The personal income of the residents of a state is the best single measure of their "ability to pay". Consequently, throughout this report, the term total revenue burden is defined as the ratio of total state and local revenues to total personal income. Similarly, the burden of a particular revenue source is defined as the ratio of its proceeds to personal income.[1]

Chart A

Total State and Local Revenue as a Percent of Personal Income
(Massachusetts, 1977-1984)

Source:
U.S. Dept. of Commerce,
Bureau of the Census,
Governmental Finances.

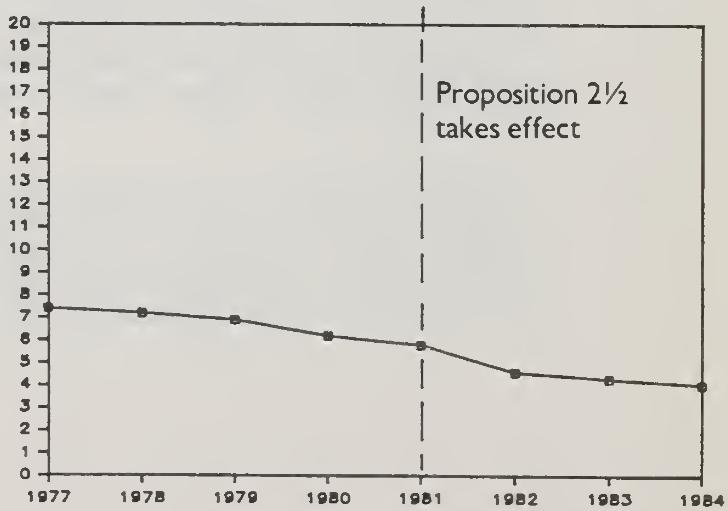


Massachusetts state and local governments claimed almost 18 percent of the incomes of its residents in 1977. By 1984, however, this percentage had plummeted to 14.7 percent (Chart A), because the property tax burden has declined. (Chart B)

Chart B

Property Tax Revenues as a Percent of Personal Income
(Massachusetts, 1977-1984)

Source:
U.S. Dept. of Commerce,
Bureau of the Census,
Governmental Finances.

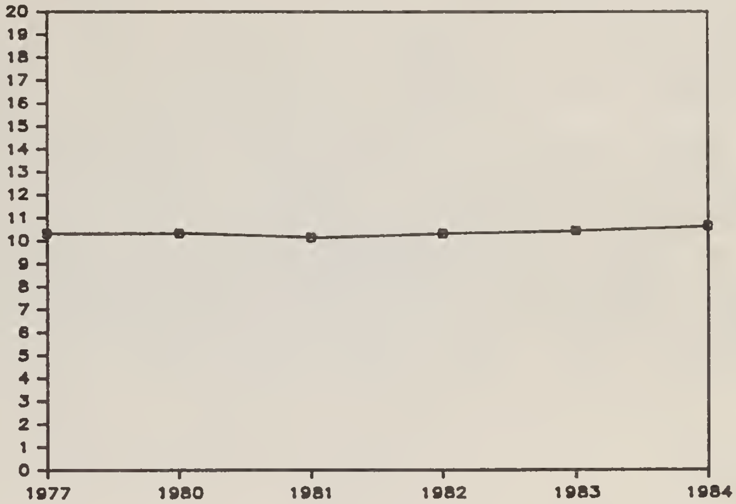


The combined burden of other revenue sources has varied little since 1977. (Chart C)

Chart C

Total State and Local Revenue Net of Property Tax
(Massachusetts, 1977-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



The property tax burden has fallen in two stages over the last eight years. During the first stage, from 1977 to 1981, several factors curtailed growth in property tax revenues. First, local aid formulas awarded aid to communities in inverse proportion to their assessed property value per capita. Consequently, local officials had an incentive to keep assessment ratios low.[2] Second, by 1977 Massachusetts' cities and towns were required to assess all property at 100% of its fair market value.[3] This requirement threatened to alter dramatically the distribution of property taxes both among and within different classes of property. In many communities it shifted burdens from businesses to homeowners. Many local officials, fearful of the political and economic consequences of such redistribution, balked at reassessing the taxable property within their jurisdictions. Third, apart from the redistributional consequences of 100% valuation, taxpayers had become disenchanted with the heavy, rising property tax burdens they had suffered throughout most of the 1970s further inducing local officials to retard growth in property taxes. Fourth, statewide growth in equalized property values was exceptionally slow during the 1977-1981 period, especially over the course of 1977 and 1978.[4] Fifth, two state tax policies mitigated the need of local governments for revenue. From 1977 to 1979, the state increased its aid to cities and towns by 66 percent, an unusually big jump.[5] In 1980, the state required all municipalities to hold annual increases in spending to 4 percent.[6] With limited authority to spend, municipalities had less need to raise revenue.

Since 1980, growth in property taxes has been limited by Proposition 2 1/2. This well-known tax limitation limits property taxes to 2.5 percent of equalized value and growth in property tax levies to 2.5 percent per year.[7] As chart B illustrates, the property tax burden dropped sharply after Proposition 2 1/2 went into effect in 1981.

While public policy has checked growth in property tax revenues, the income of Massachusetts residents has soared. Between 1977 and 1984, personal income per capita expanded by 110 percent in the Commonwealth. Over the same period, state and local revenues other than the property tax kept pace with income. However, thanks to a sluggish 11 percent increase in the property tax, total state and local revenue per capita only grew by 65 percent. (Charts D and E)

Chart D

Index of Growth in Personal Income and Total State and Local Revenue
(Massachusetts, 1977-1984)
1977 = 100

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**

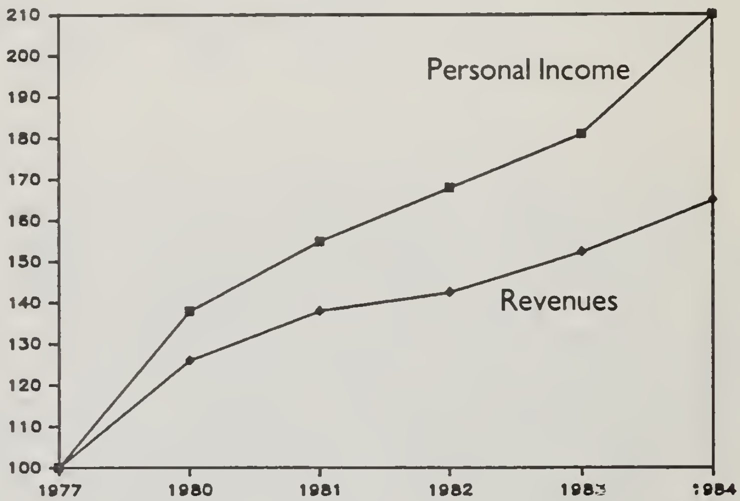
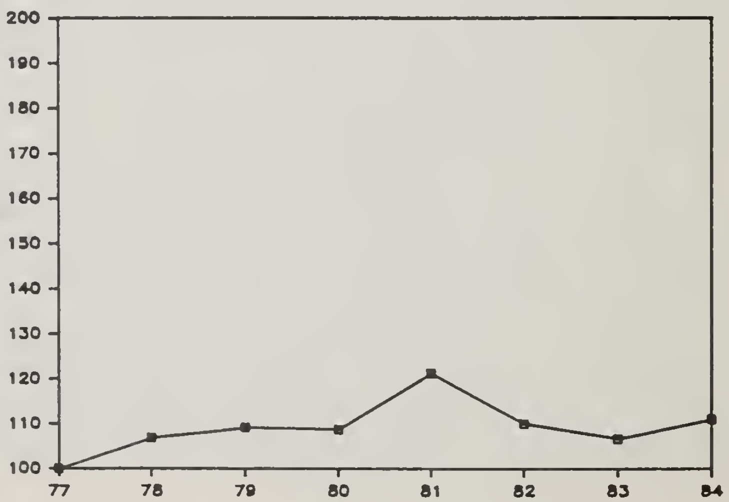


Chart E

Index of Growth in Property Tax Revenue
(Massachusetts, 1977-1984)
1977 = 100

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



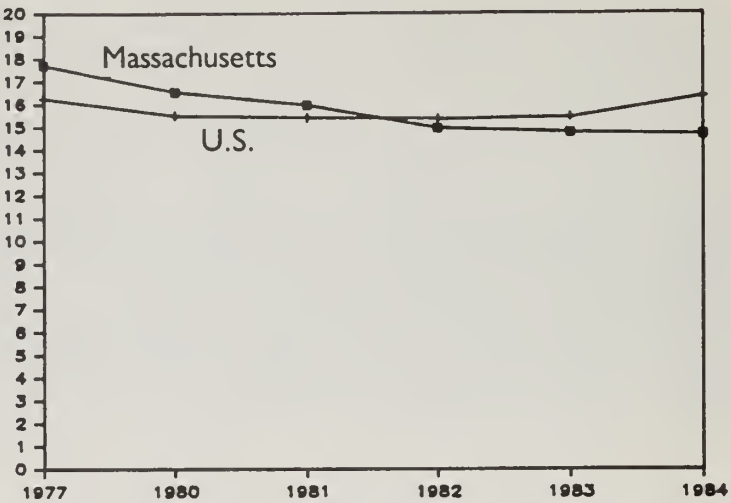
Massachusetts' economy has performed so well over the last eight years because demand for many of its most important goods and services has mushroomed. A large proportion of the Commonwealth's manufacturing sector is devoted to the production of office, computing, and accounting machinery and electrical and communication equipment. In 1977, these investment goods accounted for 26 percent of the nation's spending on machinery and equipment. By 1984, this percentage had risen to 43 percent.[8] This shift in the composition of business fixed investment has stimulated demand for "high tech"-related consulting services, another important component of Massachusetts' economy. Accelerated growth in defense-related spending has also contributed to the Commonwealth's prosperity.

The Revenue Burden in the Commonwealth is Relatively Low

Chart F

Total State and Local Revenue as a Percent of Personal Income
(Massachusetts and U.S., 1977-1984)

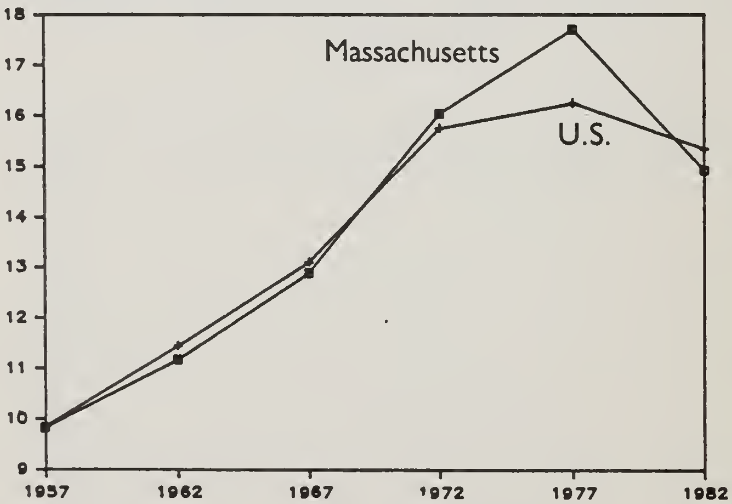
Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



As shown in Chart F, the revenue burden in the Commonwealth has been lower than that of the average of all states in the nation since 1982. In 1984 the revenue burden on Massachusetts' residents was 14.7 percent, while the national average was 16.4 percent. In fact, despite its nickname, "Taxachusetts", throughout the majority of the post-war period Massachusetts' revenue burden has been at or near the national average. (Chart G)

Chart G
Total State and Local Revenue as a Percent of Personal Income
(Massachusetts and U.S., 1957-1982)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



Do comparisons of the Massachusetts' revenue burden with the nationwide average provide a meaningful indicator of the competitiveness of is revenue system? Would it not be more appropriate to compare the Commonwealth's revenue burden with those of competitor states? In 1979 the Massachusetts High Technology Council, an interest group representing several of the Commonwealth's high technology industries, identified 17 such states. Referred to as "the social contract states", the Council divided them into three groups: the neighboring New England states, the Industrial states, and the High Technology states. (Table 1)

TABLE 1

MASSACHUSETTS' PRINCIPAL COMPETITORS AS IDENTIFIED BY THE HIGH TECHNOLOGY COUNCIL

Neighboring	High Technology	Industrial
Connecticut	Arizona	Pennsylvania
New Hampshire	California	Ohio
Rhode Island	Maryland	New York
Vermont	North Carolina	New Jersey
Maine	Texas	Michigan
	Washington	Illinois

At the time it drew up this list, the Council asserted that Massachusetts' tax system was less conducive to economic growth than most of these 17 competitors. In 1984, however, the Commonwealth's revenue burden compared favorably with the average burden in each of the three groups.

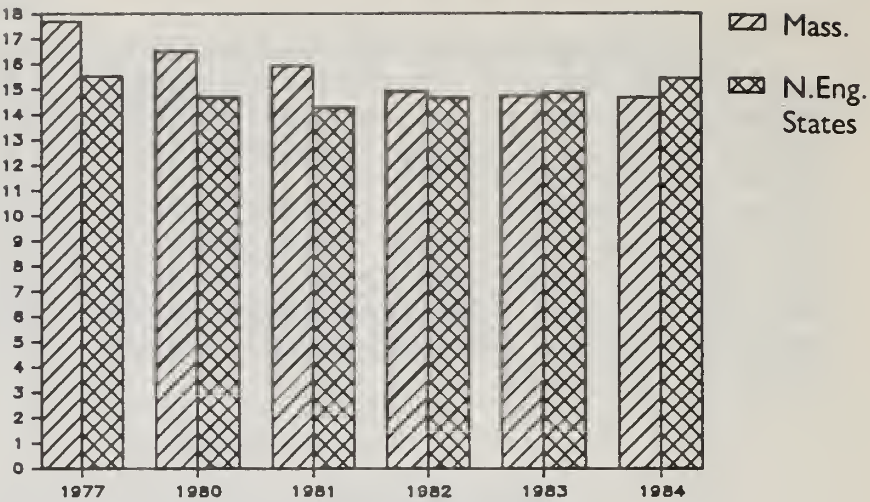
The Neighboring New England States

The Neighboring New England states are viewed as competitors primarily because of proximity. If taxes are significantly higher in Massachusetts, firms may choose to expand or relocate without much difficulty in such states as Rhode Island or Connecticut. In 1977, when the Massachusetts revenue burden was 17.7 percent, the average for the remaining New England states was only 15.6 percent. By 1984, however, as the Commonwealth's burden dropped to 14.7 percent, that of the other states dropped to only 15.4 percent. (Chart H)

Chart H

Total State and Local Revenue as a Percent of Personal Income
(Massachusetts and New England States, 1977-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



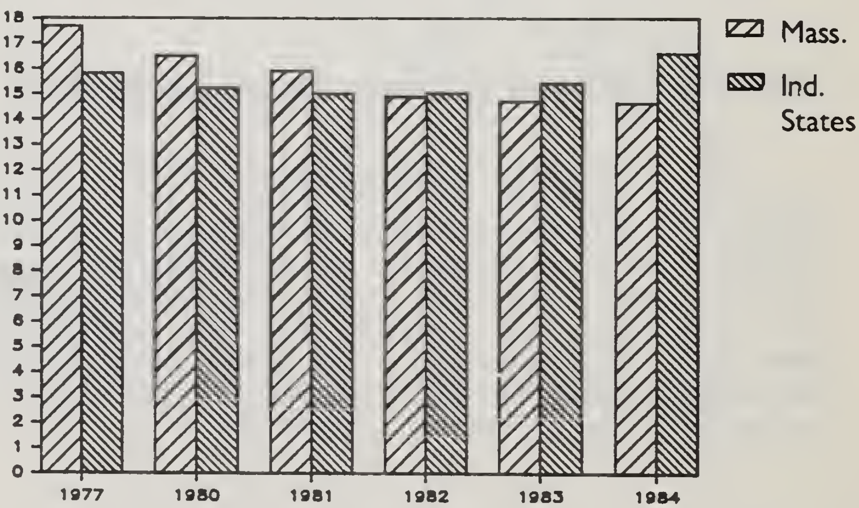
The Industrial States

The *__Industrial States__* *are viewed as competitors because they produce many of the same "traditional" industrial products that are produced in Massachusetts such as machine tools, motor vehicles, textiles, and shoes. In 1977 the revenue burden in these states averaged 15.9 percent; lower than the 17.7 percent in Massachusetts. By 1984 the burden in these states was 16.7 percent, compared to only 14.7 percent in the Commonwealth. (Chart I)*

Chart I

Total State and Local Revenue as a Percent of Personal Income
(Massachusetts and Industrial States, 1977-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



The High Technology States

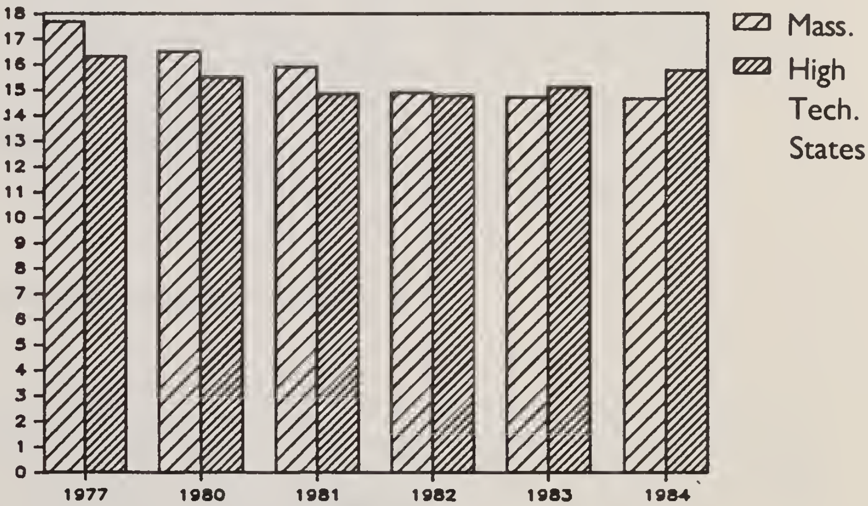
Most of the High Technology States identified by the High Technology Council are "Sunbelt States" that began to undergo industrialization during and after the Second World War. Many of these states are noted for their high concentration of such research-intensive and high growth industries as aerospace, chemicals, pharmaceuticals, and especially electronics. In 1977 the average revenue burden of these states was 16.4 percent; by 1984 it had fallen to 15.8 percent. In the same period the Commonwealth's burden fell from 17.7 percent to 14.7 percent. The burden in the Commonwealth is now lower than in the High Technology states. (Chart J)

While the revenue burden in the Commonwealth has fallen in every year since 1977, the average burden of the "High Technology" states has first fallen, and then risen. Perhaps their average revenue burden has increased over the last few years because their rapid industrialization has created a need for expanded public investment in human and physical capital.

Chart J

Total State and Local Revenue as a Percent of Personal Income
(Massachusetts and High Technology States, 1977-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



The Commonwealth's Tax Mix Differs Significantly from the National Average

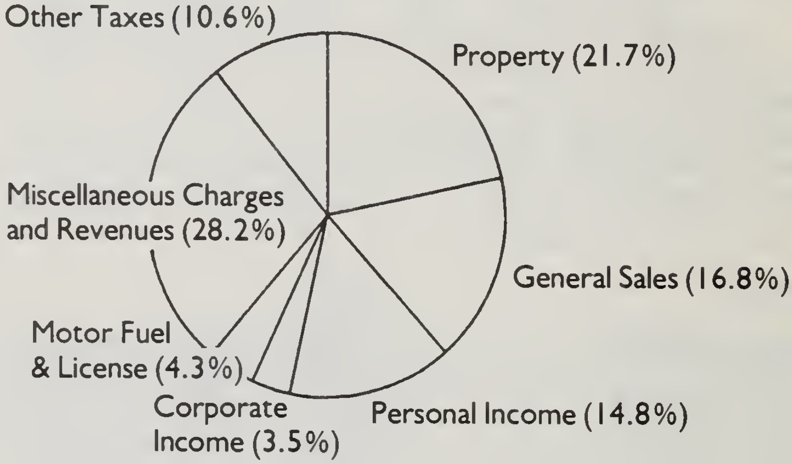
There are at least two significant differences between the composition of revenues in the Commonwealth and in other states.

[A] The Commonwealth relies much more heavily on highly visible taxes like the property tax and the personal income tax than other states as a whole. Other states tend to rely more heavily on less noticeable revenue sources such as general sales taxes, miscellaneous charges and revenues, and local non-property taxes. (Chart K)

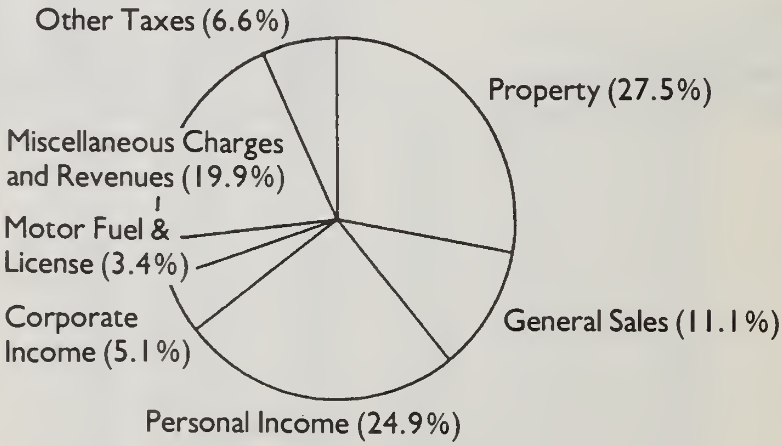
Chart K

The Mix of Massachusetts' State and Local Revenues Differs from the National Average

Nationwide Mix of State and Local Revenues, 1984



Mix of Massachusetts' Revenues, 1984



Source:
U.S. Dept. of Commerce,
Bureau of the Census,
Governmental Finances.

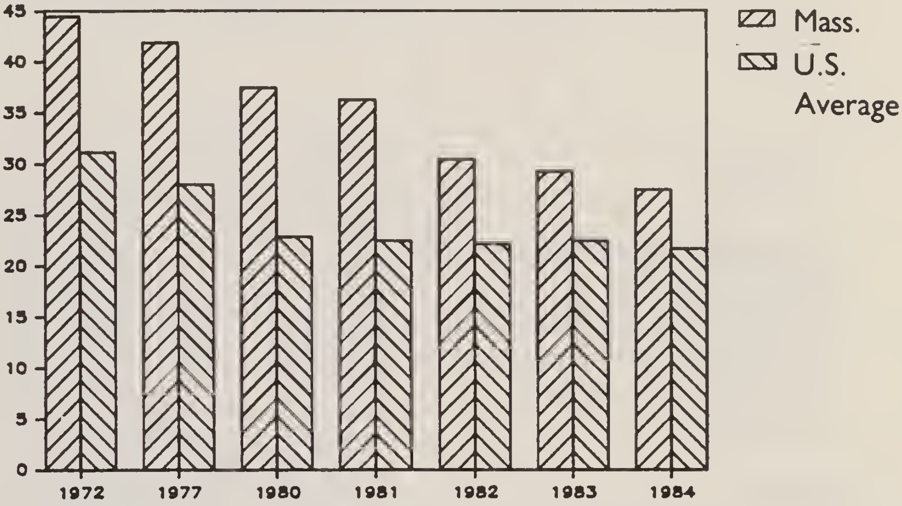
In 1984, the personal income tax accounted for 24.9 percent of Massachusetts revenue, but only 14.8 percent of state and local revenues nationwide. Out of every dollar of personal income earned in Massachusetts, the income tax claimed 3.5 cents. Nationwide, the comparable take was only 2.3 cents.

While the Commonwealth's reliance on the property tax has shrunk dramatically in recent years, it is still a high property tax state. (Chart L) Property taxes accounted for 27.5 percent of its revenues in 1984, but only 21.7 percent nationwide. While in Massachusetts, property owners paid 4 cents per dollar of personal income on property taxes, the average property owner sacrificed only 3.5 percent of his income for this purpose.

Chart L

Property Tax as a Percent of Total State and Local Revenue
(Massachusetts and U.S., 1977-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



In 1984, sales taxes and user fees and charges accounted for 45 percent of total state and local revenue collected throughout the nation, but only 31 percent in Massachusetts. In that year these two revenue sources claimed 4.5 percent of personal income in Massachusetts, compared to 7.4 percent nationwide. Even though the Commonwealth relies relatively little on sales taxation and user fees, it has made increasing use of them over the last eight years. (Charts M&N)

Chart M

Sales Tax as a Percent of Total State and Local Revenue
(Massachusetts and U.S., 1977-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**

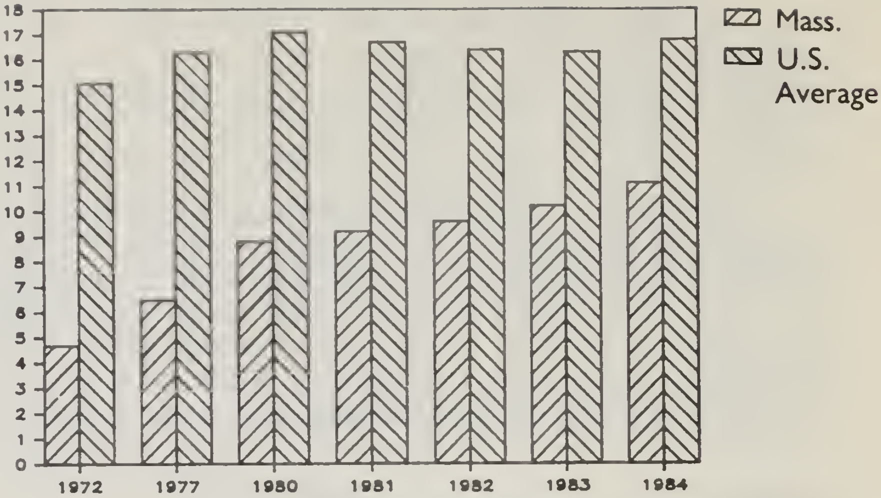
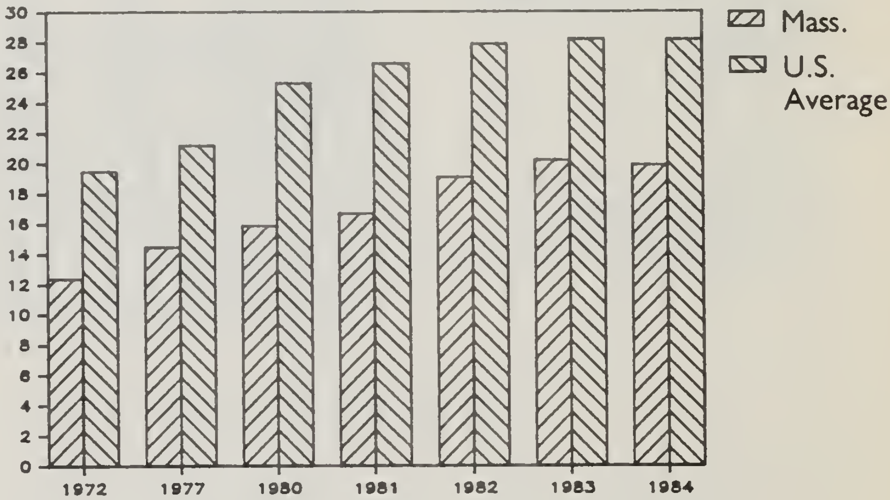


Chart N

Miscellaneous Charges and Revenues as a Percent of Total State and Local Revenue
(Massachusetts and U.S., 1977-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**

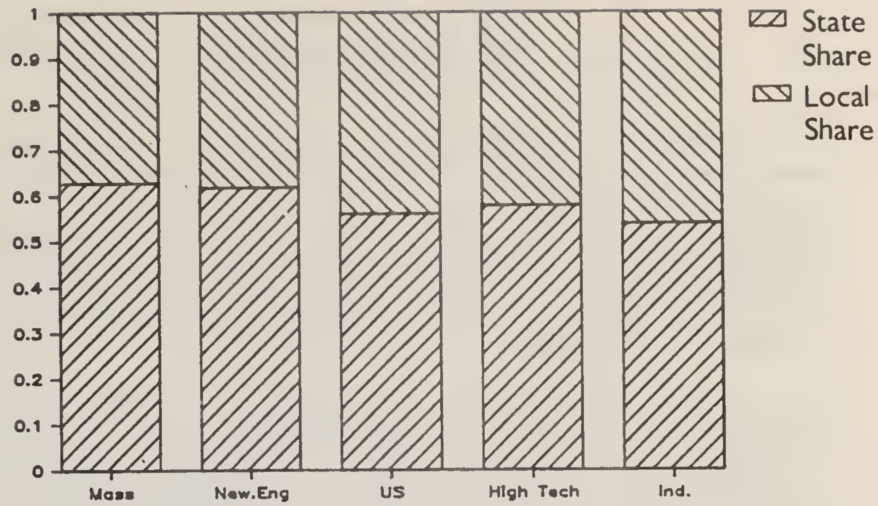


[B] In Massachusetts, State government collects a higher share of total state and local revenues (63%) than the nationwide average (56%), the average in the industrial states (54%), and the average in the High Technology states (54%). Only the New England States, whose state governments collected 62 percent of total state and local revenues in the region, have a division of fiscal authority between the state and local level similar to that of the Commonwealth. (Chart O).

Chart O

State and Local Shares of Total Revenue
(Massachusetts, U.S., and Competitor States, 1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**

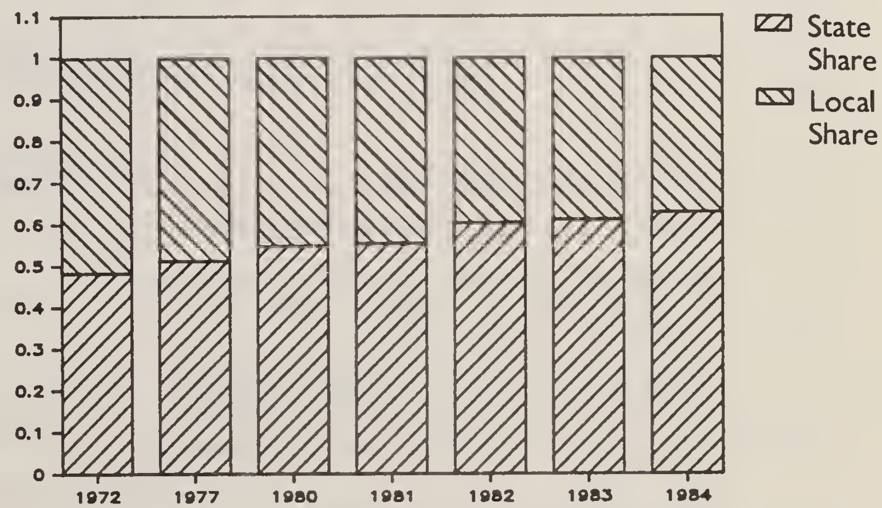


In the past, fiscal authority has been more evenly divided in Massachusetts. In 1977, 51 percent of total revenue was collected at the state level. (Chart P) Since then, constraints on property taxation, such as Proposition 2 1/2, have diminished the capacity of the Commonwealth's local governments to collect revenue, forcing the state to assume more governmental functions and expand local aid.

Chart P

State and Local Shares of Total Revenue
(Massachusetts, 1972-1984)

Source:
U.S. Dept. of Commerce, Bureau of the Census, **Governmental Finances.**



- *How might recently proposed or enacted changes in the Commonwealth's revenue system alter its revenue burden or mix?*

Two tax measures having palpable revenue effects have been enacted since the end of fiscal year 1984: a new local option tax on aircraft fuel, and an increase in the tax on hotel and motel receipts.[9] In addition, the Department of Revenue switched from worldwide unitary accounting to single entity accounting in its determination of Massachusetts' shares of the taxable incomes of multi-jurisdictional corporations.[10]

Several revenue bills with tangible revenue consequences are currently before the General Court. H.6510 would phase out the 7.5 percent surtax on the personal income tax over a 3-year period and increase the income level qualifying a household for "no tax status". S.2500 would immediately repeal the surtax and authorize other changes in the Commonwealth's tax system that would raise revenues.[11]

H.6777 would, among other things, raise the minimum value of an estate subject to estate taxation from $60,000 to $200,000 and replace the $30,000 estate tax exemption with a $1,500 credit. H.5649, the Administration's latest MassBank proposal, would earmark a portion of revenues from the corporation excise tax for infrastructure development, limit capital consumption

TABLE 2

Selected Changes in Tax Law and Their Revenue Impacts Had They Been in Effect in 1984

Changes in Tax Law	*Estimated Revenue Impact* ($ millions)*
Repeal of the income surtax	*-195*
Increase in the "no tax status" of individual income tax as proposed in H. 6510	*-11*
Change from worldwide unitary to single entity accounting	*-40*
Cut in estate tax as proposed in H.6777	*-18*
Imposition of aircraft fuel tax enacted in 1985	*+9*
Increase in hotel/motel tax enacted in 1985	*+10*
All 6 changes	*-245*

** Source of estimates: Massachusetts Special Commission on Tax Reform*

allowances, and institute a form of water's edge unitary accounting. H.6716 would grant municipalities the option of levying a 2% tax on the value of real estate at the time ownership of the property changes hands. Revenues would be earmarked for the acquisition of conservation land.

Suppose that effective fiscal year 1984 the surtax had been repealed, the "no tax status" threshold increased as recommended in H.6510, the aircraft fuel tax and hotel/motel had been enacted, the Revenue Department had switched from combined worldwide unitary accounting to single entity accounting, and the estate tax minimum threshold and exemption had been redesigned as proposed in H.6777? Tables 2 and 3 summarize the effects of these changes on the Commonwealth's revenue, revenue burden, and revenue mix. In combination they would have reduced the revenue burden from 14.7 percent to 14.4 percent, and reduced the income tax share of total revenues from 24.9 percent to 23.6 percent.

TABLE 3

Combined Impact of Selected Changes in Tax Law on Massachusetts Revenue Burden and Mix, FY 1984

	Under actual law FY 1984	If changes had been in effect FY 1984
1. Total state and local revenues/Personal Income	14.7%	14.4%
2. Income tax as a portion of total state and local revenues	24.9%	23.6%
3. Sales tax as a portion of total state and local revenues	11.1%	11.4%
4. Property tax as a portion of total state and local revenues	27.5%	28.2%
5. Corporation excise tax as a portion of total state and local revenues	5.1%	4.2%
6. User fees and charges as a portion of total state and local revenues	19.9%	20.3%
7. Other revenues as a portion of total state and local revenues	6.6%	6.8%

- *How is the Commonwealth's revenue burden likely to change in the future?*

In the absence of major changes in the Commonwealth's revenue structure other than those contained in H.6510 and S.2500, the revenue burden will continue its downward trend. As pointed out above, over the last eight years, fluctuations in the Commonwealth's total state and local revenues, minus property taxes, have practically mirrored fluctuations in state-wide personal income. Changes in property tax revenues should continue to determine shifts in the total revenue burden. Proposition 2 1/2 limits growth in each municipality's property tax levy to a maximum 2.5 percent per year. Given a long term inflation trend of about 5 percent [12], it is hard to imagine growth in personal income falling below a 2.5 percent annual rate except during a recession. Consequently, in general the ratio of property tax revenues to personal income should continue to fall.

However, growth in total revenue from sources other than the property tax should continue to keep pace with growth in income. Therefore, the property tax's share of total state and local revenues should fall, diminishing its share of total revenue and, therefore, its impact on the revenue burden. As a result, while the revenue burden should continue to fall, the rate at which it falls should moderate over time.

The downward trend in revenue burden could be interrupted by upward "blips" during economic recessions severe enough to bring growth in the Commonwealth's total personal income below an annual rate of 2.5 percent. The revenue burden could rise under such conditions because under the constraints imposed by Proposition 2 1/2, property tax revenues may grow by 2.5 percent per year.[13]

o Some questions for future research.

1. What are the limitations of interstate comparisons of revenue burdens as an indicator of a state's competitiveness?

- In choosing sites for relocation or expansion, are businesses sensitive to the burdens of some taxes more than others? Do businesses measure a tax's burden simply by dividing the revenue it raises by personal income? How do they evaluate a state's "tax climate"?

- Does the "competitiveness" of the Massachusetts tax system vary across industries and municipalities? Is the Massachusetts tax system as attractive to a manufacturer of silicon chips considering a move to a site along Route 495 as it is to a manufacturer of mens' suits considering a move to Greenfield or Springfield?

- To what extent is the burden of Massachusetts taxes exported to citizens of other states?

- If the Commonwealth's revenue burden were reduced further, how would public goods and services vital to business' productivity be affected? If the quality of these public goods and services were diminished, how would business climate be affected?

2. What analysis other than revenue mix can provide insights into the fairness of the distribution of Massachusetts state and local revenues? Would other studies better reveal which groups within the Commonwealth are paying more than their "fair share" of the cost of the public sector?

Footnotes

1. Another popular measure of overall burden is state and local revenues per capita. A thorough, sophisticated measure of burden would also take into account the degree to which burdens are exported to other states, as well as losses in economic efficiency due to tax-induced distortions of economic behavior. Such effects, however, are extremely difficult to quantify.

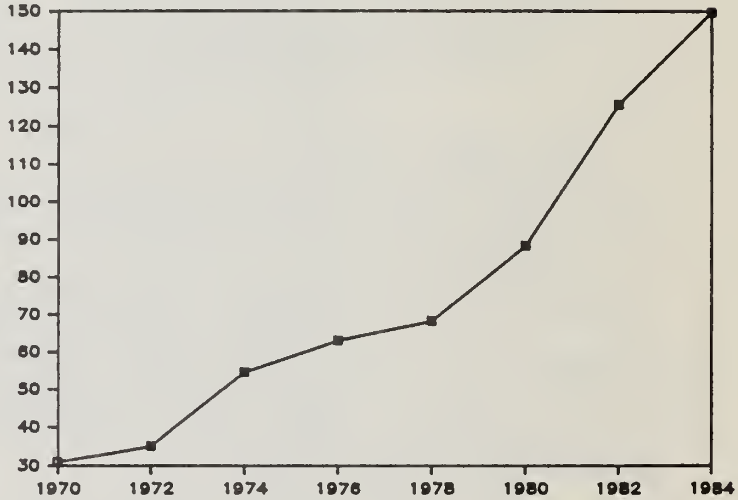
2. This incentive was present prior to 1977 as well. Consequently, the average statewide assessment ratio fell fairly steadily from 1972 to the advent of Proposition 2 1/2 in 1981.

3. 100% valuation was required by the Massachusetts Supreme Court in Town of Sudbury v. Commissioner of Corporations and Taxation. 366 Mass 558.

4. **Chart Q**

Statewide Equalized Property Value, 1970-1984
($ Billions)

Source:
Department of Revenue, unpublished data.



5. Massachusetts Department of Revenue, unpublished data.

Ch. 151 of the Acts and Resolves of 1979.

7. G.L. Ch. 59 S. 20A; S. 20B, S. 21C, and S. 21D. For more analysis of the provisions and consequences of Proposition 2 1/2, see Massachusetts House of Representatives, Committee on Ways and Means and Massachusetts Department of Revenue, Division of Local Services, Proposition 2 1/2: The Fiscal Facts, 1985. [Processed.]

8. U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, several years.

9. G.L. Ch. 64J, Ch. 64G. The General Court has also enacted a law which in effect requires savings banks to be taxed according to the same tax regime as commercial banks. [Ch. 485, of the Acts and Resolves of 1984.] Initially, the Department of Revenue forecast that this law would reduce state revenues by as much as $20 million. However, given unexpected growth in the income of savings banks, it is not clear that the law will in fact slow revenue growth.

10. The Department of Revenue switched to single entity accounting to comply with the Supreme Court's decision in Polaroid Corp. v. Commissioner of Revenue, Mass., 472 NE2d 259.

11. Among the revenue increasing measures proposed in S.2500 is a switch from single entity to "waters edge" unitary accounting.

12. This is the average annual rate of nationwide inflation between 1985 and 1986 predicted by Data Resources, Inc. in its Long Term Quarterly Review, Summer, 1985.

13. Exceptions to the limit on growth in property tax levies permit growth to exceed 2.5% under certain conditions. [G.L. Ch. 59 S. 21C Para. (c), (j), and (k).] In addition,, the 2.5% limit on levy growth can be overridden by referendum. [G.L. Ch. 59 S. 20B, 21C (e)]

ERRATA

Senate bill S.2500 described as such on page 16 also includes the following revenue reducing measures:

1). A vanishing exemption that declines with income, ranging from $1,000 to $3,000 for single returns, and from $2,000 to $6,400 for joint returns.

2). Increasing the dependent exemption from $700 to $1,000.

3). Increasing the "no tax status" limits to $6,000 for single returns and $10,000 for joint returns.